(d)(3)–(6)(i) [Reserved]. For further guidance see §1.861–11T(d)(3) through (6)(i).

(ii) Any foreign corporation if more than 50 percent of the gross income of such foreign corporation for the taxable year is effectively connected with the conduct of a trade or business within the United States and at least 80 percent of either the vote or value of all outstanding stock of such foreign corporation is owned directly or indirectly by members of the affiliated group (determined with regard to this sentence). This paragraph (d)(6)(ii) applies to taxable years beginning on or after *July 16, 2014*. See 26 CFR 1.861–11T(d)(6)(ii) (revised as of April 1, 2014) for rules applicable to taxable years beginning after August 10, 2010, and before *July 16, 2014*. See 26 CFR 1.861–11T(d)(6)(ii) (revised as of April 1, 2010) for rules applicable to taxable years beginning on or before August 10, 2010.

(7) *Special rules for the application of §1.861–11T(d)(6).* The attribution rules of section 1563(e) and the regulations under that section shall apply in determining indirect ownership under §1.861–11T(d)(6). The Commissioner shall have the authority to disregard trusts, partnerships, and pass-through entities that break affiliated status. Corporations described in §1.861–11T(d)(6) shall be considered to constitute members of an affiliated group that does not file a consolidated return and shall therefore be subject to the limitations imposed under §1.861–11T(g). The affiliated group filing a consolidated return shall be considered to constitute a single corporation for purposes of applying the rules of §1.861–11T(g). For taxable years beginning after December 31, 1989, §1.861–11T(d)(6)(i) shall not apply in determining foreign source alternative minimum taxable income within each separate category and the alternative minimum tax foreign tax credit pursuant to section 59(a) to the extent that such application would result in the inclusion of a section 936 corporation within the affiliated group. This paragraph (d)(7) applies to taxable years beginning after December 31, 1986.

(e)–(g) [Reserved]. For further guidance, see §1.861–11T(e) through (g).

(h) *Applicability dates.* This section applies to taxable years that both begin after December 31, 2017, and end on or after December 4, 2018.

[T.D. 8916, 66 FR 273, Jan. 3, 2001, as amended by T.D. 9676, 79 FR 41426, July 16, 2014; T.D. 9882, 84 FR 69068, Dec. 17, 2019]

§ 1.861–11T Special rules for allocating and apportioning interest expense of an affiliated group of corporations (temporary).

(a) *In general.* Sections 1.861–9T, 1.861–10T, 1.861–12T, and 1.861–13T provide rules that are generally applicable in apportioning interest expense. The rules of this section relate to affiliated groups of corporations and implement section 864(e) (1) and (5), which requires affiliated group allocation and apportionment of interest expense. The rules of this section apply to taxable years beginning after December 31, 1986, except as otherwise provided in §1.861–13T. Paragraph (b) of this section describes the scope of the application of the rule for the allocation and apportionment of interest expense of affiliated groups of corporations, which is contained in paragraph (c) of this section. Paragraph (d) of this section sets forth the definition of the term ''affiliated group'' for purposes of this section. Paragraph (e) describes the treatment of loans between members of an affiliated group. Paragraph (f) of this section provides rules concerning the affiliated group allocation and apportionment of interest expense in computing the combined taxable income of a FSC or DISC and its related supplier. Paragraph (g) of this section describes the treatment of losses caused by apportionment of interest expense in the case of an affiliated group that does not file a consolidated return.

(b) *Scope of application*—(1) *Application of section 864(e)(1) and (5) (concerning the definition and treatment of affiliated groups).* For further guidance, see §1.861–11(b)(1).

(2) *Nonapplication of section 864(e) (1) and (5) (concerning the definition and treatment of affiliated groups).* Section 864(e) (1) and (5) and the portions of this section implementing section 864(e) (1) and (5) do not apply to the computation of subpart F income of controlled foreign corporations (under

sections 951 through 964), the computation of combined taxable income of a possessions corporation and its affiliates (under section 936), or the computation of effectively connected taxable income of foreign corporations. For the rules with respect to the allocation and apportionment of interest expenses of foreign corporations other than controlled foreign corporations, see §§ 1.882–4 and 1.882–5.

(c) *General rule for affiliated corporations.* Except as otherwise provided in this section, the taxable income of each member of an affiliated group within each statutory grouping shall be determined by allocating and apportioning the interest expense of each member according to apportionment fractions which are computed as if all members of such group were a single corporation. For purposes of determining these apportionment fractions, stock in corporations within the affiliated group (as defined in section 864(e)(5) and the rules of this section) shall not be taken into account. In the case of an affiliated group of corporations that files a consolidated return, consolidated foreign tax credit limitations are computed for the group in accordance with the rules of § 1.1502–4. Except as otherwise provided, all the interest expense of all members of the group will be treated as definitely related and therefore allocable to all the gross income of the members of the group and all the assets of all the members of the group shall be taken into account in apportioning this interest expense. For purposes of this section, the term ''taxpayer'' refers to the affiliated group (regardless of whether the group files a consolidated return), rather than to the separate members thereof.

(d)(1)–(2) [Reserved]. For further guidance, see § 1.861–11(d)(1) and (2).

(3) *Treatment of life insurance companies subject to taxation under section 801*—(i) *General rule.* A life insurance company that is subject to taxation under section 801 shall be considered to constitute a member of the affiliated group composed of companies not taxable under section 801 only if a parent corporation so elects under section 1504(c)(2)(A) of the Code. If a parent does not so elect, no adjustments shall be required with respect to such an insurance company under paragraph (g) of this section.

(ii) *Treatment of stock.* Stock of a life insurance company that is subject to taxation under section 801 that is not included in an affiliated group shall be disregarded in the allocation and apportionment of the interest expense of such affiliated group.

(4) *Treatment of certain financial corporations*—(i) *In general.* In the case of an affiliated group (as defined in paragraph (d)(1) of this section), any member that constitutes financial corporations as defined in paragraph (d)(4)(ii) of this section shall be treated as a separate affiliated group consisting of financial corporations (the ''financial group''). The members of the group that do not constitute financial corporations shall be treated as members of a separate affiliated group consisting of nonfinancial corporations (''the nonfinancial group'').

(ii) *Financial corporation defined.* The term ''financial corporation'' means any corporation which meets all of the following conditions:

(A) It is described in section 581 (relating to the definition of a bank) or section 591 (relating to the deduction for dividends paid on deposits by mutual savings banks, cooperative banks, domestic building and loan associations, and other savings institutions chartered and supervised as savings and loan or similar associations);

(B) Its business is predominantly with persons other than related persons (within the meaning of section 864(d)(4) and the regulations thereunder) or their customers; and

(C) It is required by state or Federal law to be operated separately from any other entity which is not such an institution.

(iii) *Treatment of bank holding companies.* The total aggregate interest expense of any member of an affiliated group that constitutes a bank holding company subject to regulation under the Bank Holding Company Act of 1956 shall be prorated between the financial group and the nonfinancial group on the basis of the assets in the financial and nonfinancial groups. For purposes of making this proration, the assets of each member of each group, and not the stock basis in each member, shall be taken into account. Any direct or indirect subsidiary of a bank holding company that is predominantly engaged in the active conduct of a banking, financing, or similar business shall be considered to be a financial corporation for purposes of this paragraph (d)(4). The interest expense of the bank holding company must be further apportioned in accordance with § 1.861–9T(f) to the various section 904(d) categories of income contained in both the financial group and the nonfinancial group on the basis of the assets owned by each group. For purposes of computing the apportionment fractions for each group, the assets owned directly by a bank holding company within each limitation category described in section 904(d)(1) (other than stock in affiliates or assets described in § 1.861–9T(f)) shall be treated as owned pro rata by the nonfinancial group and the financial group based on the relative amounts of investments of the bank holding company in the nonfinancial group and financial group.

(iv) *Consideration of stock of the members of one group held by members of the other group.* In apportioning interest expense, the nonfinancial group shall not take into account the stock of any lower-tier corporation that is treated as a member of the financial group under paragraph (d)(4)(i) of this section. Conversely, in apportioning interest expense, the financial group shall not take into account the stock of any lower-tier corporation that is treated as a member of the nonfinancial group under paragraph (d)(4)(i) of this section. For the treatment of loans between members of the financial group and members of the nonfinancial group, see paragraph (e)(1) of this section.

(5) *Example.* (i) *Facts.* X, a domestic corporation which is not a bank holding company, is the parent of domestic corporations Y and Z. Z owns 100 percent of the stock Z1, which is also a domestic corporation. X, Y, Z, and Z1 were organized after January 1, 1987, and constitute an affiliated group within the meaning of paragraph (d)(1) of this section. Y and Z are financial corporations described in paragraph (d)(4) of this section. X also owns 25 percent of the stock of A, a domestic corporation. Y owns 25 percent of the voting stock of B, a foreign corporation that is not a controlled foreign corporation. Z owns less than 10 percent of the voting stock of C, another foreign corporation. The foreign source income generated by Y's or Z's direct assets is exclusively financial services income. The foreign source income generated by X's or Z1's direct assets is exclusively general limitation income. X and Z1 are not financial corporations described in paragraph (d)(4)(ii) of this section. Y and Z, therefore, constitute a separate affiliated group apart from X and Z1 for purposes of section 864(e). The combined interest expense of Y and Z of $100,000 ($50,000 each) is apportioned separately on the basis of their assets. The combined interest expense of X and Z1 of $50,000 ($25,000 each) is allocated on the basis of the assets of the XZ1 group.

Analysis of the YZ group assets

Adjusted basis of assets of the YZ group that generate foreign source financial services income (excluding stock of foreign subsidiaries not included in the YZ affiliated group)	$200,000
Z's basis in the C stock (not adjusted by the allocable amount of C's earnings and profits because Z owns less than 10 percent of the stock) which would be considered to generate passive income in the hands of a nonfinancial services entity but is considered to generate financial services income when in the hands of Z, a financial services entity	$100,000
Y's basis in the B stock (adjusted by the allocable amount of B's earnings and profits) which generates dividends subject to a separate limitation for B dividends	$100,000
Adjusted basis of assets of the YZ group that generate U.S. source income	$600,000
Total assets	$1,000,000

Analysis of the XZ1 group assets

Adjusted basis of assets of the XZ1 group that generate foreign source general limitation income	$500,000
Adjusted basis of assets of the XZ1 group other than A stock that generate domestic source income	$1,900,000
X's basis in the A stock adjusted by the allocable amount of A's earnings and profits	$100,000
Total domestic assets	$2,000,000
Total assets	$2,500,000

(ii) *Allocation.* No portion of the $50,000 deduction of the YZ group is definitely related solely to specific property within the meaning of § 1.861–10T. Thus, the YZ group's deduction for interest is related to all its activities and properties. Similarly, no portion of the $50,000 deduction of the XZ1 group is definitely related solely to specific property within the meaning of §1.861–10T. Thus, the XZ1 group's deduction for interest is related to all its activities and properties.

(iii) *Apportionment*. The YZ group would apportion its interest expense as follows:

To gross financial services income from sources outside the United States:

$$\$50{,}000 \times \frac{\$300{,}000}{\$1{,}000{,}000} \ldots\ldots \$15{,}000$$

To gross income subject to a separate limitation for dividends from B:

$$\$50{,}000 \times \frac{\$100{,}000}{\$1{,}000{,}000} \ldots\ldots \$5{,}000$$

To gross income from sources inside the United States:

$$\$50{,}000 \times \frac{\$600{,}000}{\$1{,}000{,}000} \ldots\ldots \$30{,}000$$

The XZ1 group would apportion its interest expense as follows:

To gross general limitation income from sources outside the United States:

$$\$50{,}000 \times \frac{\$500{,}000}{\$2{,}500{,}000} \ldots\ldots \$10{,}000$$

To gross income from sources inside the United States:

$$\$50{,}000 \times \frac{\$2{,}000{,}000}{\$2{,}500{,}000} \ldots\ldots \$40{,}000$$

(6) *Certain unaffiliated corporations*. Certain corporations that are not described in paragraph (d)(1) of this section will nonetheless be considered to constitute affiliated corporations for purposes of §§1.861–9T through 1.861–13T. These corporations include:

(i) Any includible corporation (as defined in section 1504(b) without regard to section 1504(b)(4)) if 80 percent of either the vote or value of all outstanding stock of such corporation is owned directly or indirectly by an includible corporation or by members of an affiliated group, and

(ii) [Reserved]. For further guidance see §1.861–11(d)(6)(ii).

(7) *Special rules for the application of §1.861–11T(d)(6)*. [Reserved]. For special rules for the application of §1.861–11T(d)(6), see §1.861–11(d)(7).

(e) *Loans between members of an affiliated group*—(1) *General rule*. In the case of loans (including any receivable) between members of an affiliated group, as defined in paragraph (d) of this section, for purposes of apportioning interest expense, the indebtedness of the member borrower shall not be considered an asset of the member lender. However, in the case of members of separate financial and nonfinancial groups under paragraph (d)(4) of this section, the indebtedness of the member borrower shall be considered an asset of the member lender and such asset shall be characterized by reference to the member lender's income from the asset as determined under paragraph (e)(2)(ii) of this section. For purposes of this paragraph (e), the terms "related person interest income" and "related person interest payment" refer to interest paid and received by members of the same affiliated group as defined in paragraph (d) of this section.

(2) *Treatment of interest expense within the affiliated group*—(i) *General rule*. A member borrower shall deduct related person interest payments in the same manner as unrelated person interest expense using group apportionment fractions computed under §1.861–9T(f). A member lender shall include related person interest income in the same class of gross income as the class of gross income from which the member borrower deducts the related person interest payment.

(ii) *Special rule for loans between financial and nonfinancial affiliated corporations*. In the case of a loan between two affiliated corporations only one of which constitutes a financial corporation under paragraph (d)(4) of this section, the member borrower shall allocate and apportion related person interest payments in the same manner as unrelated person interest expense using group apportionment fractions computed under §1.861–9T(f). The source of the related person interest income to the member lender shall be determined under section 861(a)(1).

(iii) *Special rule for high withholding tax interest.* In the case of an affiliated corporation that pays interest that is high withholding tax interest under §1.904–5(f)(1) to another affiliated corporation, the interest expense of the payor shall be allocated to high withholding tax interest.

(3) *Back-to-back loans.* If a member of the affiliated group makes a loan to a nonmember who makes a loan to a member borrower, the rule of paragraphs (e) (1) and (2) of this section shall apply, in the Commissioner's discretion, as if the member lender made the loan directly to the member borrower, provided that the loans constitute a back-to-back loan transaction. Such loans will constitute a back-to-back loan for purposes of this paragraph (e) if the loan by the nonmember would not have been made or maintained on substantially the same terms irrespective of the loan of funds by the lending member to the nonmember or other intermediary party.

(4) *Examples.* The rules of this paragraph (e) may be illustrated by the following examples.

Example 1. X, a domestic corporation, is the parent of Y, a domestic corporation. X and Y were organized after January 1, 1987, and constitute an affiliated group within the meaning of paragraph (d)(1) of this section. Among X's assets is the note of Y for the amount of $100,000. Because X and Y are members of an affiliated group, Y's note does not constitute an asset for purposes of apportionment. The apportionment fractions for the relevant tax year of the XY group are 50 percent domestic, 40 percent foreign general, and 10 percent foreign passive. Y deducts its related person interest payment using those apportionment fractions. Of the $10,000 in related person interest income received by X, $5,000 consists of domestic source income, $4,000 consists of foreign general limitation income, and $1,000 consists of foreign passive income.

Example 2. X is a domestic corporation organized after January 1, 1987. X owns all the stock of Y, a domestic corporation. On June 1, 1987, X loans $100,000 to Z, an unrelated person. On June 2, 1987, Z makes a loan to Y with terms substantially similar to those of the loan from X to Z. Based on the facts and circumstances of the transaction, it is determined that Z would not have made the loan to Y on the same terms if X had not made the loan to Z. Because the transaction constitutes a back-to-back loan, as defined in paragraph (e)(3) of this section, the Commissioner may require, in his discretion, that neither the note of Y nor the note of Z may be considered an asset of X for purposes of this section.

(f) *Computations of combined taxable income.* In the computation of the combined taxable income of any FSC or DISC and its related supplier which is a member of an affiliated group under the pricing rules of sections 925 or 994, the combined taxable income of such FSC or DISC and its related supplier shall be reduced by the portion of the total interest expense of the affiliated group that is incurred in connection with those assets of the group used in connection with export sales involving that FSC or DISC. This amount shall be computed by multiplying the total interest expense of the affiliated group and interest expense of the FSC or DISC by a fraction the numerator of which is the assets of the affiliated group and of the FSC or DISC generating foreign trade income or gross income attributable to qualified export receipts, as the case may be, and the denominator of which is the total assets of the affiliated group and the FSC or DISC. Under this rule, interest of other group members may be attributed to the combined taxable income of a FSC or DISC and its related supplier without affecting the amount of interest otherwise deductible by the FSC or DISC, the related supplier or other member of the affiliated group. The FSC or DISC is entitled to only the statutory portion of the combined taxable income, net of any deemed interest expense, which determines the commission paid to the FSC or DISC or the transfer price of qualifying export property sold to the FSC or DISC.

(g) *Losses created through apportionment*—(1) *General rules.* In the case of an affiliated group that is eligible to file, but does not file, a consolidated return and in the case of any corporation described in paragraph (d)(6) of this section, the foreign tax credits in any separate limitation category are limited to the credits computed under the rules of this paragraph (g). As a consequence of the affiliated group allocation and apportionment of interest expense required by section 864(e)(1) and this section, interest expense of a group member may be apportioned for section 904 purposes to a limitation category in which that member has no gross income, resulting in a loss in that limitation category. The same is true in connection with any expense other than interest that is subject to apportionment under the rules of section 864(e)(6) of the Code. Any reference to ''interest expense'' in this paragraph (g) shall be treated as including such expenses. For purposes of this paragraph, the term ''limitation category'' includes domestic source income, as well as the types of income described in section 904(d)(1) (A) through (I). A loss of one affiliate in a limitation category will reduce the income of another member in the same limitation category if a consolidated return is filed. (See §1.1502–4.) If a consolidated return is not filed, this netting does not occur. Accordingly, in such a case, the following adjustments among members are required in order to give effect to the group allocation of interest expense:

(i) Losses created through group apportionment of interest expense in one or more limitation categories within a given member must be eliminated; and

(ii) A corresponding amount of income of other members in the same limitation category must be recharacterized.

Such adjustments shall be accomplished, in accordance with paragraph (g)(2) of this section, without changing the total taxable income of any member and before the application of section 904(f). Section 904(f) (including section 904(f)(5)) does not apply to a loss created through the apportionment of interest expense to the extent that the loss is eliminated pursuant to paragraph (g)(2)(ii) of this section. For purposes of this section, the terms ''limitation adjustment'' and ''recharacterization'' mean the recharacterization of income in one limitation category as income in another limitation category.

(2) *Mechanics of computation*—(i) *Step 1: Computation of consolidated taxable income.* The members of an affiliated group must first allocate and apportion all other deductible expenses other than interest. The members must then deduct from their respective gross incomes within each limitation category interest expense apportioned under the rules of §1.861–9T(f). The taxable income of the entire affiliated group within each limitation category is then totalled.

(ii) *Step 2: Loss offset adjustments.* If, after step 1, a member has losses in a given limitation category or limitation categories created through apportionment of interest expense, any such loss (*i.e.*, the portion of such loss equal to interest expense) shall be eliminated by offsetting that loss against taxable income in other limitation categories of that member to the extent of the taxable income of other members within the same limitation category as the loss. If the member has taxable income in more than one limitation category, then the loss shall offset taxable income in all such limitation categories on a pro rata basis. If there is insufficient domestic income of the member to offset the net losses in all foreign limitation categories caused by the apportionment of interest expense, the losses in each limitation category shall be recharacterized as domestic losses to the extent of the taxable income of other members in the same respective limitation categories. After these adjustments are made, the income of the entire affiliated group within each limitation category is totalled again.

(iii) *Step 3: Determination of amount subject to recharacterization.* In order to determine the amount of income to be recharacterized in step 4, the income totals computed under step 1 in each limitation category shall be subtracted from the income totals computed under step 2 in each limitation category.

(iv) *Step 4: Recharacterization.* Because any differences determined under step 3 represent deviations from the consolidated totals computed under Step 1, such differences (in any limitation category) must be eliminated.

(A) *Limitation categories to be reduced.* In the case of any limitation category in which there is a positive change, the income of group members with income in that limitation category must be reduced on a pro rata basis (by reference to net income figures as determined under Step 2) to the extent of such positive change (''limitation reductions''). Each member shall separately compute the sum of the limitation reductions.

(B) *Limitation categories to be increased.* In any case in which only one limitation category has a negative change in Step 3, the sum of the limitation reductions within each member is added to that limitation category. In the case in which multiple limitation categories have negative changes in Step 3, the sum of the limitation reductions within each member is prorated among the negative change limitation categories based on the ratio that the negative change for the entire group in each limitation category bears to the total of all negative changes for the entire group in all limitation categories.

(3) *Examples.* The following examples illustrate the principles of this paragraph.

Example 1. (i) *Facts.* X, a domestic corporation, is the parent of domestic corporations Y and Z. X, Y, and Z were organized after Janaury 1, 1987, constitute an affiliated group within the meaning of paragraph (d)(1) of this section, but do not file a consolidated return. The XYZ group apportions its interest expense on the basis of the fair market value of its assets. X, Y, and Z have the following assets, interest expense, and taxable income before apportioning interest expense:

Assets	X	Y	Z	Total
Domestic	2,000.00	0	1,000.00	3,000.00
Foreign Passive	0	50.00	50.00	100.00
Foreign General	0	700.00	200.00	900.00
Interest expense	48.00	12.00	80.00	140.00
Taxable Income (pre-interest):				
Domestic	100.00	0	63.00	163.00
Foreign Passive	0	5.00	5.00	10.00
Foreign General	0	60.00	35.00	95.00

(ii) *Step 1: Computation of consolidated taxable income.* Each member of the XYZ group apportions its interest expense according to group apportionment ratios determined under the asset method decribed in §1.861–9T(f), yielding the following results:

Apportioned interest expense	X	Y	Z	Total
Domestic	36.00	9.00	60.00	105.00
Foreign Passive	1.20	0.30	2.00	3.50
Foreign General	10.80	2.70	18.00	31.50
Total	48.00	12.00	80.00	140.00

The members of the group then compute taxable income within each category by deducting the apportioned interest expense from the amounts of pre-interest taxable income specified in the facts in paragraph (i), yielding the following results:

Taxable income	X	Y	Z	Total
Domestic	64.00	9.00	3.00	58.00
Foreign Passive	−1.20	4.70	3.00	6.50
Foreign General	−10.80	57.30	17.00	63.50
Total	52.00	53.00	23.00	128.00

(iii) *Step 2: Loss offset adjustments.* Because X and Y have losses created through apportionment, these losses must be eliminated by reducing taxable income of the member in other limitation categories. Because X has a total of $12 in apportionment losses and because it has only one limitation category with income (*i.e.*, domestic), domestic income must be reduced by $12, thus eliminating its apportionment losses. Because Y has a total of $9 in apportionment losses and because it has two limitation categories with income (*i.e.*, foreign passive and foreign general limitation), the income in these two limitation categories must be reduced on a pro rata basis in order to eliminate its apportionment losses. In summary, the following adjustments are required:

Loss offset adjustments	X	Y	Z	Total
Domestic	−12.00	+9.00	0	−3.00
Foreign Passive	+1.20	−0.68	0	+0.52
Foreign General	+10.80	−8.32	0	+2.48

These adjustments yield the following adjusted taxable income figures:

Adjusted taxable income	X	Y	Z	Total
Domestic	52.00	0	3.00	55.00
Foreign Passive	0	4.02	3.00	7.02
Foreign General	0	48.98	17.00	65.98
Total	52.00	53.00	23.00	128.00

(iv) *Step 3: Determination of amount subject to recharacterization.* The adjustments performed under Step 2 led to a change in the group's taxable income within each limitation category. The total loss offset adjustments column shown in paragraph (iii) above shows the net deviations between Step 1 and 2.

(v) *Step 4: Recharacterization.* The loss offset adjustments yield a positive change in the foreign passive and the foreign general limitation categories. Y and Z both have income in these limitation categories. Accordingly, the income of Y and Z in each of these limitation categories must be reduced on a pro rata basis (by reference to the adjusted taxable income figures) to the extent of the positive change in each limitation category. The total positive change in the foreign passive limitation category is $0.52. The adjusted taxable income of Y in the foreign passive limitation category is $4.02 and the adjusted taxable income of Z in the foreign passive limitation category is $3. Therefore, $0.30 is drawn from Y and $0.22 is drawn from Z. The total positive change in the foreign general limitation category is $2.48. The adjusted taxable income of Y in the foreign general limitation category is $48.98, and the adjusted taxable income of Z in the foreign general limitation category is $17. Therefore, $1.84 is drawn from Y and $.64 is drawn from Z.

The members must then separately compute the sum of the limitation reductions. Y has limitation reductions of $0.30 in the foreign passive limitation category and $1.84 in the foreign general limitation category, yielding total limitation reduction of $2.14. Under these facts, domestic income is the only limitation category requiring a positive adjustment. Accordingly, Y's domestic income is increased by $2.14. Z has limitation reductions of $0.22 in the foreign passive limitation category and $0.64 in the foreign general limitation category, yielding total limitation reductions of $0.86. Under these facts, domestic income is the only limitation category of Z requiring a positive adjustment. Accordingly, Z's domestic income is increased by $0.86.

Recharacterization adjustments	X	Y	Z	Total
Domestic	0	+ 2.14	+ 0.86	+ 3.00
Foreign Passive	0	− 0.30	− 0.22	− 0.52
Foreign General	0	− 1.84	− 0.64	− 2.48

These recharacterization adjustments yield the following final taxable income figures:

Final taxable income	X	Y	Z	Total
Domestic	52.00	2.14	3.86	58.00
Foreign Passive	0	3.72	2.78	6.50
Foreign General	0	47.14	16.36	63.50
Total	52.00	53.00	23.00	128.00

Example 2. (i) *Facts.* X, a domestic corporation, is the parent of domestic corporations Y and Z. X, Y, and Z were organized after January 1, 1987, constitute an affiliated group within the meaning of paragraph (d)(1) of this section, but do not file a consolidated return. Moreover, X has served as the sole borrower in the group and, as a result, has sustained an overall loss. The XYZ group apportions its interest expense on the basis of the fair market value of its assets. X, Y, and Z have the following assets, interest expense, and taxable income before interest expense:

Assets	X	Y	Z	Total
Domestic	2,000	0	1,000	3,000
Foreign Passive	0	50	50	100
Foreign General	0	700	200	900
Interest Expense	140	0	0	140
Taxable Income (pre-interest):				
Domestic	100	0	100	200
Foreign Passive	0	5	5	10
Foreign General	0	70	35	105

(ii) *Step 1: Computation of consolidated taxable income.* Each member of the XYZ group apportions its interest expense according to group apportionment ratios determined under the asset method described in §1.861–9T(g), yielding the following results:

Apportioned interest expense	X	Y	Z	Total
Domestic	105.00	0	0	105.00
Foreign Passive	3.50	0	0	3.50
Foreign General	31.50	0	0	31.50
Total	140.00	0	0	140.00

The members of the group then compute taxable income within each category by deducting the apportioned interest expense from the amounts of pre-interest taxable income specified in the facts in paragraph (i), yielding the following results:

Taxable income	X	Y	Z	Total
Domestic	− 5.00	0	100.00	95.00
Foreign Passive	− 3.50	5.00	5.00	6.50
Foreign General	− 31.50	70.00	35.00	73.50
Total	− 40.00	75.00	140.00	175.00

(iii) *Step 2: Loss offset adjustment.* Because X has insufficient domestic income to offset the sum of the losses in the foreign limitation categories caused by apportionment, the amount of apportionment losses in each limitation category shall be recharacterized as domestic losses to the extent of taxable income of other members in the same limitation category. This is accomplished by adding to each foreign limitation categories an amount equal to the loss therein and by subtracting the sum of such foreign losses from domestic income, as follows:

Loss offset adjustments	X	Y	Z	Total
Domestic	− 35.00	0	0	− 35.00
Foreign Passive	+ 3.50	0	0	+ 3.50
Foreign General	+ 31.50	0	0	+ 31.50

These adjustments yield the following adjusted taxable income figures:

Adjusted taxable income	X	Y	Z	Total
Domestic	−40	0	100	60
Foreign Passive	0	5	5	10
Foreign General	0	70	35	105
Total	−40	75	140	175

(iv) *Step 3: Determination of amount subject to recharacterization.* The adjustments performed under Step 2 led to a change in the group's taxable income within each limitation category. The total loss offset adjustment column shown in paragraph (iii) above shows the net deviations between Steps 1 and 2.

(v) *Step 4: Recharacterization.* The loss offset adjustments yield a positive change in the foreign passive and the foreign general limitation categories. Y and Z both have income in these limitation categories. Accordingly, the income of Y and Z in each of these limitation categories must be reduced on a pro rata basis (by reference to the adjusted taxable income figures) to the extent of the positive change in each limitation category. The total positive change in the foreign passive limitation category is $3.50. The adjusted taxable income of Y in the foreign passive limitation category is $5, and the adjusted taxable income of Z in the foreign passive limitation category is $5. Therefore, $1.75 is drawn from Y and $1.75 is drawn from Z. The total positive change in the foreign general limitation category is $31.50. The adjusted taxable income of Y in the foreign general limitation category is $70, and the adjusted taxable income of Z in the foreign general limitation category is $35. Therefore, $21 is drawn from Y and $10.50 is drawn from Z.

The members must then separately compute the sum of the limitation reductions. Y has limitation reductions of $1.75 in the foreign passive limitation category and $21 in the foreign general limitation category, yielding total limitation reductions of $22.75. Under these facts, domestic income is the only limitation category requiring a positive adjustment. Accordingly, Y's domestic income is increased by $22.75. Z has limitation reductions of $1.75 in the foreign passive limitation category and $10.50 in the foreign general limitation category, yielding total limitation reductions of $12.25. Under these facts, domestic income is the only limitation category requiring a positive adjustment. Accordingly, Z's domestic income is increased by $12.25.

Recharacterization adjustments	X	Y	Z	Total
Domestic	0	+22.75	+12.25	+35.00
Foreign Passive	0	−1.75	−1.75	−3.50
Foreign General	0	−21.00	−10.50	−31.50

These recharacterization adjustments yield the following final taxable income figures:

Final taxable income	X	Y	Z	Total
Domestic	−40.00	22.75	112.25	95.00
Foreign Passive	0	3.25	3.25	6.50
Foreign General	0	49.00	24.50	73.50
Total	−40.00	75.00	140.00	175.00

(h) *Effective/applicability date.* In general, the rules of this section apply for taxable years beginning after December 31, 1986.

[T.D. 8228, 53 FR 35490, Sept. 14, 1988, as amended by T.D. 8916, 65 FR 274, Jan. 3, 2001; T.D. 9456, 74 FR 38875, Aug. 4, 2009; T.D. 9571, 77 FR 2227, Jan. 17, 2012; 77 FR 9844, Feb. 21, 2012; T.D. 9676, 79 FR 41426, July 16, 2014; T.D. 9882, 84 FR 69069, Dec. 17, 2019]

§ 1.861–12 Characterization rules and adjustments for certain assets.

(a) *In general.* The rules in this section apply to taxpayers apportioning expenses under an asset method to income in the various separate categories described in § 1.904–5(a)(4)(v), and supplement other rules provided in §§ 1.861–9 through 1.861–11T. The principles of the rules in this section also apply in apportioning expenses among statutory and residual groupings for any other operative section. See also § 1.861–8(f)(2)(i) for a rule requiring conformity of allocation methods and apportionment principles for all operative sections. Paragraph (b) of this section describes the treatment of inventories. Paragraph (c)(1) of this section concerns the treatment of various stock assets. Paragraph (c)(2) of this section describes a basis adjustment for stock in 10 percent owned corporations. Paragraph (c)(3) of this section sets forth rules for characterizing the stock in controlled foreign corporations. Paragraph (c)(4) of this section describes the treatment of stock of noncontrolled 10-percent owned foreign corporations. Paragraph (d)(1) of this section concerns the treatment of notes. Paragraph (d)(2) of this section concerns the treatment of notes of controlled foreign corporations. Paragraph